

Multistate Tax Commission



TO: PPWG – UNIFORMITY COMMITTEE LIAISON GROUP

FROM: ALAN H. FRIEDMAN, MODERATOR

SUBJECT: MAY 26, 1999 TELECONFERENCE

DATE: MAY 19, 1999

I know that this may be a bit early for me to get something out in advance of our May 26th, 1:30 PM (Eastern) teleconference, but I wanted to give you some time to think about what we are doing here and to work to improve the draft language some more. To that end, I am faxing/e-mailing the Group members' brief minutes of the Subgroup teleconferences of May 12th, a few questions to ponder, and a redraft of the Three Unities Test to review.

Please gather your thoughts and deliver your comments (either in writing before the teleconference or orally during the teleconference) to me. Again, call 703-736-7307 and ask for the Multistate Tax Commission PPWG meeting with me as the moderator.

I hope to hear from all of you on the 26th.

Minutes of Teleconference Meetings of Subgroup on
Unity of Ownership/Functional Integration, Unity of Operations/Economies of
Scale, and Unity of Use/Centralized Management of PPWG – Uniformity
Committee Liaison Group on Definitions of Unitary Business

May 12, 1999
11:30 AM (Eastern)
Unity of Ownership Subgroup

The Unity of Ownership Subgroup tried, but failed, to meet. It appears that the “Tax Gods/Devils” that follow all of us around convinced Vialog, our teleconferencing service, to lose all record of the scheduled conference. Some of us were told that no conference existed; others were put together without a Moderator. (Rumor has it that the Moderator-less group made a tremendous amount of progress.)

The issues concerning this Subgroup will be addressed at our next call of the full Group set for May 26th at 1:30 PM (Eastern).

May 12, 1999
1:30 PM (Eastern)
Unity of Operations Subgroup

After experiencing the morning’s wrath of the “Tax Gods/Devils”, your Moderator believed that “it could only get better” from there. How wrong could I have been! The Unity of Operations Subgroup did manage to find one another; however, we were assaulted **EVERY** four minutes by a high-pitched noise on the line that lasted at least a minute each time.

But, this hearty band of Subgroup participants was not about to be driven off by the sirens of the “Tax Gods/Devils”, no matter what eardrum damage was being suffered. The Subgroup hung in there long enough to re-draft the latest version of the “unity of operation” element to provide as set forth under the “Proposed Three Unities Test (May 13, 1999 Draft)” below.

May 12, 1999
4:30 PM (Eastern)
Unity of Use Subgroup

The Unity of Use Subgroup met as scheduled, without any interference from the “Tax Gods/Devils”. It agreed to the changes that were accepted by the Unity of Operations Subgroup. So the current draft of its basic element is shown under the “Proposed Three Unities Test (May 13, 1999 Draft)” below.

The Subgroup members then agreed to a suggestion that IRC Regulations 882 *et al.* be reviewed to see if the concept of “stewardship” could be incorporated in this definition.

DISCUSSION TOPICS FOR FULL PPWG-UNIFORMITY LIAISON GROUP FOR MARCH 26TH TELECONFERENCE.

Please review the attached May 13, 1999 draft of the Three Unites Test and note any part or parts that you wish to address during our March 26th teleconference. I would appreciate your specific input on the illustrations I have provided. The illustrations are much too simplistic to be very educational; therefore, please ratchet them up with more difficulty to provide more teaching effect.

In addition, please give thought to the following issues.

Unity of Ownership

It is important for the full Group to decide finally whether it will address the element of “ownership” in the definition of a “unitary business” for purposes of combined reporting. If so, I would expect that all could agree that direct or indirect ownership of 50+% of the company to be combined, with actual control through such voting power, permits combination. But, what if there is:

1. 50+% ownership, but no control by a single person or entity? North Dakota’s *True* case held no combination where practice was to determine corporate matters by consensus among the shareholders, even though one shareholder held more than 50% interest. Here, there was no control in fact; therefore, no combination.
2. Less than 50+% owned by any one person, but those holding a total of 50+% together had a common interest or bond? California’s *Rain Bird* case held such common interest (family members) holding 50+% sufficient under the statute for combination.
3. Less than 50+% interest held by single person, but held right to elect majority of Board through stock warrants, if exercised? California’s *Rockwell* case held this insufficient to allow combination.

If the full Group does not tackle the above issues, does any ownership interest at all satisfy the “unity of ownership” element for income apportionment purposes?

Unity of Operations

1. Should the fact that the entity sought to be combined pays or reimburses at “arms-length” prices its parent for contributed staff services?

Unity of Use

1. What oversight activities are properly classified as acts of “stewardship” over an investment; and what activities are properly classified as operational oversight?

PROPOSED THREE UNITIES TEST

May 13, 1999 Draft

I. Three Unities Test for Determining a Unitary Business.

A. Definitions.

For the purposes of this section, the following definitions shall apply and control:

1. "Business" means a single entity or two or more entities under common ownership or control with respect to which [this State's income/franchise tax] law requires a determination of whether the activities of the entity or entities within and without this State constitute one or more unitary businesses within this State.
2. "Entity" means each type of organization that [this State's income/franchise law] recognizes as a reporting person, except such term does not include an individual or [insert other applicable exceptions].
3. "Segment" means a subdivision of an entity consisting of any grouping of business activities, functions or transactions.

B. Three Unities Test.

A unitary business includes each entity or segment of a business among which there exists a unity of ownership; and a unity of operation or a unity of use, or both.

1. The "unity of ownership" element of this test is satisfied when one or more entities directly or indirectly owns, in whole or in part, an ownership interest in each entity sought to be included in the unitary business. **[The unity of ownership element may be satisfied for apportionment of income purposes even though an entity owns less than a 50+% ownership in the entity sought to be included in the unitary business.]** **[However, to determine whether entities that are included within the same unitary business may be combined for income reporting purposes, see the ownership requirements set forth in []].**

Illustrations of this “ownership” element include, but are not limited to, the following:

- a. Pulpwood Furniture, Inc. (hereafter “P”) has purchased 80% of the outstanding shares of a company (Middle Co., Inc.) which owns 70% of the outstanding shares of Sapwood Manufacturing Co., Inc. (hereafter “S”). P, therefore, indirectly owns 56% of the voting interests of S; and, absent any shareholder agreement or other fact, P has majority control (at least 50+%) over S.
- b. Same facts as in a. above, except that P has agreed with the minority shareholders of S that it would assign to an independent third person the right to vote 7% of the shares of S, so long as P was in the furniture business. P, therefore, owns a majority (at least 50+%) of the outstanding voting shares of S, but P does not control S.
- c. P has purchased 45% of the outstanding shares of S and also holds warrants to purchase an additional 10% of S’s outstanding shares. P has neither ownership or control of S at this point.

2. The “unity of operations” element of this test is satisfied when each entity or segment within such entity that is to be included within the unitary business receives services, support, guidance or direction from common staff resources, personnel or functions.

Illustrations of this “operations” element include, but are not limited to, the following:

- a. *Common purchasing:* Corporation P and its wholly owned subsidiary S are manufacturers of furniture; but P manufactures its own line of contemporary furniture and S manufactures reproductions of antique furniture. Both purchase the wood pieces necessary for their production from the same company, Forest Levelor. Each P and S realizes a small price discount due to the total volume purchased by P and S.
- b. *Common advertising:* Corporations P and S employ the same advertising firm, Fuut, Conehead and Belting that purchases advertising space in national magazines. Because of the amount of advertising space purchased by

both P and S in the same magazine, S receives a slight discount on its ad fees.

- c. *Common sales force:* Both P and S use the same independent contractor to sale their respective furniture lines to retailers around the United States. Neither P, nor S, realizes any commission savings by doing so.
- d. *Common accounting:* For most accounting purposes, P relies on its internal accounting department. S relies on P's accounting department and pays P on an arms-length basis the hourly cost of P's accounting work. For auditing purposes, S uses Big Five and P uses Bigger Three accounting firms.
- e. *Common legal support:* For most non-litigation purposes, P uses its in-house counsel. S also uses P's in-house counsel and pays P on an arms-length basis the hourly cost of P's counsels' work.

P's General Counsel oversees all litigation concerning P and its subsidiaries and hires outside counsel depending upon the type of claim at issue.

- f. *Common retirement plan:* P and S had different retirement plans and differences in required employee contributions, with S's plan being more generous to its employees. P and S terminated both plans and created one joint plan for employees of P and any of its subsidiaries.

P and S had different retirement plans and differences in required employee contributions, with S's plan being more generous to its employees. Instead of merging the two or terminating both retirement plans and creating another, P sweetened its plan to match that of

- g. *S.Common insurance coverage:* After its acquisition, S's employees were required to enroll in P's health care plan and S's old plan was terminated.
- h. *Common marketing:* The internal marketing department of P provides all of the marketing requirements of both P an S. S reimburses P for the full cost of using its marketing department personnel.
- i. *Common cash management:* Both P and S maintain separate bank accounts for their operating fund needs. However, on a quarterly basis, P requires S to pay over to P's Treasurer all excess cash not needed for the operation of S's day-to-day operations. P's Treasurer then invests

P's and S's excess cash in a mixture of short and long-term investments.

- j. *Common research and development:* Before P had acquired S, S had a highly accomplished research lab team that specialized in the development and use of various resins necessary in finishing of furniture. P had full access to the use of S's lab and paid S an amount estimated as its share of the costs that directly supported P's needs.
- k. *Common offices:* After acquiring S, P enlarged the premises of its lease for its offices to add another floor. P subleases the added floor – at arms-length price per square foot – to S.
- l. *Common manufacturing facilities:* After P acquired S, P moved a part of its lathing operation into the factory that S had been occupying. P then acquired additional space for manufacturing a block from S's factory to maximize the efficiency of its lathing operation.
- m. *Common warehousing facilities:* P owns a warehouse in which it stores its entire inventory. After acquiring S, P permitted S to store some of its furniture production in the warehouse at arms-length price per square foot.
- n. *Common transportation facilities:* P and S use the same common carrier for their shipments of furniture. Due to the overall volume shipped by P and S, P is given a small discount by the carrier.

P and S each own several trailers. Both hire contract carriers to use their tractors to pull P and S's trailers to their destination. Due to the overall volume shipped by P and S, P is given a small discount by the carriers.
- o. *Common computer systems and support:* After its acquisition by P, S got rid of all of its typewriters and bought computer equipment that would network with P's. P's Information Systems people assisted in the integration of the two systems and now fully support S's systems and computer needs. S pays P for the cost of P's providing these computer services at an arms-length hourly rate.
- p. *Financing support:* In order to acquire S, P was required to take out a loan from its bank. The bank insisted on having S's assets pledged as additional collateral for the loan.

After its acquisition by P, S's President decided to open an "exotic bird" emporium. He envisioned hatching and growing exotic birds to be sold along with S's reproduction antiques. S's bank required P to sign as guarantor for the new venture. Even though every member of P's Board was not in favor of the "Bird on a Stick of Furniture" venture, it did not rise to the dollar level of P's Board approval, so P's President executed the guaranty.

3. The 'unity of use' element of this test is satisfied when each entity or segment within such entity that is to be included within the unitary business receives services, support, guidance or direction from common line or executive resources, personnel, or functions.

Illustrations of this "use" element include, but are not limited to, the following:

- a. *Common management:* Three of P's inside Board members comprise three of seven of S's Board membership.

P's Chief Operating Officer is the President of S.

- b. *Control of major policies:* P's Board of Directors requires that it approve any acquisition by either P or S of any interest in any other company.

P's Board of Directors requires that it approve any lending of in excess of \$50,000 to any one or more of either P or S's suppliers.

- c. *Inter-entity transactions:* P sells all of its scrap wood to S at arms-length prices. Scrap amounts to about 4% of P's wood purchases.

S has licensed to P for 10 years, at arms-length fees, the use of a resin developed in S's lab. P uses the resin on about 10% of its production.

- d. *Common policy/training manuals:* P's Employee Handbook has been expanded to apply to all of S's employees.

S's employees are required to attend P's employee training courses.

Disciplinary procedures are the same for both P and S's employees, although the appeal is only through their respective entities.

- e. *Required budgetary approval:* P's Board of Directors requires that it approve the budget and expenditure plans of S when S intends to increase its budget plan by more than 5% over the previous fiscal year.
- f. *Required capital asset purchase approval:* P's Board of Directors requires that it approve any capital expenditure by S in excess of \$50,000.

B. Facts and Circumstances; Presumptions.

The determination under paragraph B. of whether an entity or segment forms part of a unitary business with another shall be determined by the facts and circumstances of each case. It shall be presumed, subject to rebuttal, that a unitary business exists between entities or segments when the "unity of ownership" and either the "unity of operation" or the "unity of use" elements have been satisfied.